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COMMISSIONERS
GARY PIERCE, Chairman
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PAUL NEWMAN
BRENDA BURNS

IN THE MATTER OF THE APPLICATION OF GOODMAN WATER COMPANY, AN ARIZONA CORPORATION, FOR (i) A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND (ii) AN INCREASE IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

DOCKET NO. W-02500A-10-0382

STAFF'S OPENING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above captioned matter. The brief addresses the disputed issues regarding the Proposed Settlement Agreement dated September 15, 2011, between Goodman Water Company ("Goodman" or "Company"), and Intervenors James Schoemperlen, Lawrence Wawrzyniak, and the Residential Utility Consumer Office ("RUCO"). On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

Goodman Water Company is an Arizona for-profit, Class C public service corporation providing water service to approximately 600 customers in the vicinity of Oracle in Pinal County, Arizona. On September 17, 2010, Goodman filed an application for a permanent rate increase, requesting a return on a $2,402,222 fair value rate base ("FVRB"). Goodman's Rebuttal testimony requests a $262,717 (44.19 percent) revenue increase to provide a $227,309 operating income for a 9.89 percent rate of return on a $2,298,376 FVRB.

A hearing in this matter commenced on July 26,2011, continued through July 28,2011, and was scheduled to reconvene on September 12 and 13, 2011, until vacated to accommodate preparation of a settlement agreement and supporting testimony by some of the parties (Goodman and Intervenors RUCO, Lawrence Wawryzniak and James Schoemperlen) that had come to terms regarding significant disputed issues. Staff was not invited to participate in the settlement discussions and was unaware that the discussions were taking place until an agreement in principle had been

reached regarding the rate application.

The Proposed Settlement Agreement was filed on September 15, 2011. Pursuant to a September 15, 2011, Procedural Order, the parties to the Proposed Settlement Agreement submitted testimony in support of the agreement. Thereafter, Staff submitted its Supplemental Staff Report, which addressed the Proposed Settlement Agreement and the settling parties' supporting testimony. The Staff Report identifies reasons the Proposed Settlement Agreement as filed should not be adopted and identifies an alternative that preserves most of the Proposed Settlement Agreement's claimed benefits while avoiding certain problems that the agreement presents.

Staff's Supplemental Staff Report also updates its previously filed schedules and proposes a revenue requirement of $797,063. This represents an increase of $202,604, or 34.08 percent, over test year revenue of $594,459 for a 9.2 percent rate of return on a Staff-adjusted FVRB of $2,077,253. Staff's updated revenue requirement represents a $21,780 increase from its initial Surrebuttal testimony. Staff's updated revenue requirement reflects a correction to remove Advances in Aid of Construction related to mains that were double counted in the calculation of accumulated deferred income taxes; adjustments to Land and Structures and Improvements to recognize the fully-allocated cost of purchases from an affiliate; and the consequential effects on depreciation expense, accumulated depreciation, property and income taxes and rate design.

Staff recognizes the efforts and cooperation of the parties to the Proposed Settlement Agreement in attempting to resolve the issues in this case. However, there are elements of that agreement with which Staff cannot agree. These include the 'black box' nature of the settlement terms, which leaves undecided those issues which must be resolved in order to serve as a basis for any future rate application that may be filed, and the deferral of both accumulated depreciation and annual depreciation expense.

II. A BLACK BOX FORMAT FAILS TO ESTABLISH THE ELEMENTS REQUIRED FOR A FUTURE RATE CASE.

The Proposed Settlement Agreement states: "The parties present agreed that the settlement would take the form of a "black box" format in which only the specific issues identified herein would be agreed to but that no specific revenue/expense, or rate base adjustments would be specifically

delineated."[1] A determination on the issue of excess capacity was expressly postponed to the next rate case, and without that determination, there can be no determination of plant excluded or accumulated depreciation balances.

Although this language in the Proposed Settlement Agreement would suggest that none of the underlying elements, those which would be necessary for determining the revenue requirement in a future rate case has been agreed upon, at hearing, both RUCO[2] and the Company[3] presented testimony to the effect that the specific terms proposed by RUCO in the Surrebuttal testimony of Timothy J Coley and William A. Rigsby constituted the various elements upon which the revenue requirement and rates could be based, and that the Recommended Opinion & Order could so indicate without violating the terms of the Proposed Settlement Agreement.

Adoption of the of RUCO's position as set forth in its Surrebuttal testimony would resolve most of the problems created by a 'black box' agreement and would provide sufficient information on which to base a future rate case. One exception is the determination of the value of the land, together with structures and improvements thereon which were transferred to the Company by an affiliate. NARUC Guidelines for Cost Allocations and Affiliate Transactions provide that the transfer of assets from an affiliate should be at the lower of market price or net book value and that an appraisal should be conducted to determine market price.[4] The Company proposed recording the value of the land and improvements based on an appraisal conducted by John Ferenchak, III,[5] (the "Appraisal") but declined to provide the book value of the land, structures and improvements.[6] Staff's pre-settlement position was that the parcels should be excluded from rate base until the Company provided the requested information and that, in the meantime, the 2009 Pinal County Assessor's Full Cash Value should be used as a place holder.[7]

In arriving at its FVRB of $1,755,118, RUCO assigns the land, structures and improvements a lower value than that contained in the Appraisal, but utilizes a theory which might suggest that it also

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[1] Proposed Settlement Agreement, at paragraph 1.15.
[2] Tr. Vol. V at 871:24-872:16.
[3] Tr. Vol. IV at 755:15-756:6.
[4] Ex. S-19 at 11 (Surrebuttal Test. of Gordon L. Fox).
[5] Tr. Vol. II 236:9-17; Ex. S-19 at11-15 (Surrebuttal Test. of Gordon L. Fox).
[6] Ex. S-19 at 12 (Surrebuttal Test. of Gordon L. Fox).
[7] Ex. S-19 at 17 (Surrebuttal Test. of Gordon L. Fox).

adopts the appraisal value urged by the Company. RUCO's Surrebuttal Testimony states the Appraisal's value of the land but discounts it by a standardized percentage to reflect the portion that it deems to be used and useful.[8] Arguably, this could be interpreted as adopting the Company's valuation. For this reason, Staff continues to assert that the Proposed Settlement Agreement not be adopted. However, in the event that it is adopted, any order should clarify that the land valuation on which the Proposed Settlement Agreement is based is not adopted and shall be determined in a future rate case.

III. DEFERRAL OF DEPRECIATION AS PROPOSED IS CONTRARY TO ACCOUNTING AND RATEMAKING PRINCIPLES ADOPTED BY THIS COMMISSION.

A. No Accounting Methodology Exists to Defer Accumulated Depreciation.

The Proposed Settlement Agreement includes a provision that Goodman is authorized, for rate-making purposes, to "defer $269,307 of accumulated depreciation through the end of the test year."[9] The very concept is self-contradictory: accumulated depreciation is that which has been accumulated and recorded or 'taken' while depreciation that is deferred has not been 'taken' or recorded. Given that the same depreciation cannot be both recognized as an expense in or before the test year and deferred to a future date, it appears that, in effect, the Proposed Settlement Agreement attempts to undo or void the recording of accumulated depreciation that existed at the end of the test year.

However, no accepted methodology for either voiding or deferring depreciation which has already been accrued exists. The Commission has adopted NARUC's Uniform System of Accounts (USOA); neither the USOA nor Generally Accepted Accounting Principles (GAAP) provides for such a deferral or reversal of recorded accumulated depreciation.[10] In fact, certain provisions of USOA and GAAP indicate that such a reversal is improper. The USOA states:

> All prior period adjustments to retained earnings shall be approved by the Commission....Generally the **only** type of transactions which will be considered as a prior period adjustment are correction of an error in the financial statements of a prior period, or adjustments that result from realization of income tax benefits of pre-acquisition loss carry-forwards of purchased subsidiaries.

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[8] Ex. RUCO-8 at Surrebuttal Schedule TJC-6 (Surrebuttal Test. of Timothy J. Coley).
[9] Proposed Settlement Agreement, at Paragraph 2.3.
[10] Tr.955:23-956:15.

In the present case, the accumulation of depreciation could not be considered an error, nor is it among the types of transaction which can be changed. Thus any changes in depreciation or amortization amounts would not be considered an error and would not be allowed as an adjustment to retained earnings.[11]

Other authorities support Staff's position in this regard. *The Regulation of Public Utilities Theory and Practice,* by Charles F. Phillips, Jr, states: "If therefore, public utilities fail to make adequate charges to cover depreciation costs and do not accumulate the necessary depreciation reserves, they cannot increase their charges at a later time in order to recover deficiencies from customers."[12] While not directly addressing the issue in this case, Mr. Phillips' statement is another indication that depreciation and accumulated depreciation amounts should be recorded properly and not manipulated.[13]

B. <u>Deferral Of Either Accumulated Depreciation Or Annual Depreciation Expense Results In Rates That Are Neither Fair Nor Reasonable.</u>

1. Intergenerational Transfer Of Costs.

Among the most basic precepts of cost-of-service ratemaking is that rates should be based on the cost of service to the customers who create those costs.[14] The deferral of depreciation in this case will almost certainly result in an intergenerational transfer of those costs to future ratepayers. At issue in this case, and unresolved by the Proposed Settlement Agreement, is the issue of whether there is excess capacity in the system. Both Goodman and Staff have presented extensive evidence that there is no excess capacity at this time. Only the Interveners dispute this.

The plant in controversy includes a storage tank and mains. Without a determination or even a consensus that this plant is not used and useful, it is highly likely that, when the issue of excess capacity resurfaces in the next rate case, at least a portion of the excluded plant will be deemed to have been used and useful. In this case, Goodman has agreed to a stay-out period of more than three years, with the earliest test year occurring in 2014. This plant was placed in service in 2008. By the

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[11] Tr.958:6-12.
[12] Charles F. Phillips, Jr,, *The Regulation of Public Utilities Theory and Practice,* p.247.
[13] Tr.961:8-10.
[14] *Regulated Utilities Manual,* Deloitte, p. 6; Fox Transcript p. 964, l.0-17.

time this plant is included in rates, no earlier than early 2016, it is anticipated that growth will have occurred and that the new ratepayers can help in paying for the plant in question. However, by that time, the current residents will have had approximately eight years of use of the plant but the cost thereof will be shifted to new home owners.

This also raises the specter of retroactive ratemaking. Retroactive ratemaking occurs when future rates permit a utility to recoup past losses or refund excessive past income. This can include changes in accounting methodology which impact past losses or gains.[15] For instance, the Court in *Montana-Dakota Utility Company vs. Public Service Commission*[16] found that retroactive ratemaking had occurred when the public service commission required a utility to re-compute its unamortized investment tax credit balance to reflect a 26 year period rather than the 20 year period the utility had computed.

The District of Columbia Circuit of the United States Court of Appeals has also acknowledged that changing accounting methodology can result in retroactive ratemaking in *Town Of Norwood, Massachusetts v. Federal Energy Regulatory Commission.*[17] That case involved a change from cash basis to an accrual accounting method for treatment of post-retirement benefits other than pensions, primarily retiree medical benefits. Switching from pay-as-you-go to accrual accounting results in a large liability – the transition obligation. That liability may be amortized over 20 years. The Court ruled that, because the company was not shifting any costs that it should have collected in the past, it was not retroactive ratemaking. (Both methods were a means of having present employees bear the cost of their own retirement benefits in the future and the cost being recovered would always have been collected in the future.)

This might suggest that the deferral of depreciation here is retroactive ratemaking. However, Arizona has not so ruled, and there exists little case law in this area to provide guidance. Arizona recognizes the rule against retroactive ratemaking, but, to date, has not addressed any circumstances other than those wherein rates were adjusted as either too high or too low and the difference was to be

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[15] Krieger, Stephan H., *The Ghost Of Regulation Past: Current Applications Of The Rule Against Retroactive Ratemaking In Public Utility Proceedings,* University of Illinois Law Review, 1991, at p. 998.

[16] *Montana-Dakota Utility Company vs. Public Service Commission,* 431N.W.2D 276 (N.D.1988).

[17] *Town Of Norwood, Massachusetts v. Federal Energy Regulatory Commission,* 162 P.U.R.4th 214, 53 F.3d 377, 311 U.S.App.D.C. 306 (1995).

recouped or refunded in new rates.[18] Nor did the Courts of Appeals find that retroactive ratemaking had occurred. Both involved cases wherein the Commission had approved rates only to later order that amounts it determined to have been excessive must be refunded. In *Pueblo Del Sol,* the rates in question were interim rates, not final rates, so the rule did not apply. In *Mountain States*, the Commission had not set aside its own rate order. That order was mandated to be set aside by the Arizona Court of Appeals, so the rule was inapplicable.

2. Goodman Will Receive The Benefit Of Accumulated Depreciation Twice.

Perhaps more concerning than the issue of retroactive ratemaking, is the impact that the terms of the agreement will have on current ratepayers and future ratepayers who have neither created the cost nor agreed to its deferral. As noted, Goodman has already recorded its accumulated depreciation balance at the end of the 2010 test year. The books have been closed on that year and previous years and cannot now be re-opened and amended. The ratepayers who paid rates in 2010 and before bore the costs of the excluded tank in the rates they paid. This cannot be undone. Therefore, if the Company is permitted to defer that accumulated depreciation until the next rate case sometime after January 1, 2015, the accumulated depreciation will be included in rates again and the customers will pay for that a second time.

3. Ratepayers Will Overpay Annual Depreciation Expense.

The Proposed Settlement Agreement does not specify how the deferred depreciation will be treated, only that it will be deferred. Company witness Thomas J. Bourassa testified that it was his understanding that the deferred depreciation, both the accumulated depreciation of $269,307 and the annual depreciation expenses of $44,136, would be addressed at the next rate hearing and that, in the interim, that depreciation would be accumulated.[19] Mr. Rigsby concurred with this position[20]. By the

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[18] Arizona case law provides little guidance in the present circumstance. In *Pueblo Del Sol Water Co. v. Arizona Corp. Commission*, 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (App. 1988). The Arizona Court of Appeals stated, "Retroactive rate making occurs when the Commission requires refunds of charges fixed by a formal finding which has become final."18 In *Mountain States Tel. & Tel. Co. v. Arizona Corp. Commission,* 124 Ariz. 433, 436, 604 P.2d 1144, 1147 (App. 1979), the court stated: "When an agency approves a rate, and the rate becomes final, the agency may not later on its own initiative or as the result of collateral attack make a retroactive determination of a different rate and require reparations."

[19] Tr. 768:7-769:18.

[20] Tr. 873:9-874:16.

end of the 2014 test year, the amount accumulated would be $489,987. This amount would then be amortized and included in rates as an operating expense.

This gives rise to multiple concerns. First is the extent to which the Commission in a future rate case would allow the depreciation to be recovered. The USOA provides that such a regulatory asset be maintained in a separate account, but also states that "If rate recovery of all or part of an amount included in this account is disallowed, the disallowed amount shall be charged to Account 426 – Miscellaneous Nonutility Expenses, or Account 434 – Extraordinary Deductions, in the year of the disallowance."[21] Given the significant impact of a disallowance, it is unlikely that the Commission will not, in the future, disallow it.

Second is the financial impact this will have on ratepayers. If there is no deferral and the accumulated and annual depreciation are considered in this rate case, then there will be the $269,307 accumulated depreciation which is a reduction in rate base, and one year of annual depreciation expense of $44,136. In contrast, if the deferral is authorized, the next rate case will include recovery of the accumulated depreciation balance and four years of annual depreciation deferred in addition to the on-going depreciation expense of the test year. Thus future ratepayers will be paying not only their own on-going annual depreciation, but also the amortized annual and accumulated depreciation deferrals. The Proposed Settlement Agreement's omission of the specified treatment exposes future ratepayers not only to the amortization expense but also to the potential that the deferred amount could be included in rate base, which, as previously noted, would be the likely outcome. Under that assumption, Staff's alternative is really more appealing for the ratepayer in the long term because, even though he must pay a little more up front, he does not pay as much in the long run.

C. Staff's Alternative Achieves the Same Rates Without Relying on Questionable Accounting Practices.

It is a long-recognized legal maxim that hard cases make bad law. In this case, the parties to the Proposed Settlement Agreement have agreed to rates which are acceptable to all parties, but base those rates on methods inconsistent with those adopted by the Commission. This creates the risk that other utilities will rely on this methodology in future cases. Although the Proposed Settlement

[21] USOA 186.3(D).

Agreement specifies that it relies on a black-box method and that no specific terms have been agreed to, all parties thereto have now agreed that the specifics posed by RUCO in its Surrebuttal testimony may be adopted to support the rates of the Proposed Settlement Agreement.[22]

Yet the concept of deferral of depreciation remains. As noted, it is not accepted by either the USOA or GAAP and it results in rates that are not fair and reasonable and that require future generations of ratepayers to bear the cost of plant used by current ratepayers. It is more than a timing issue, despite the implications to the contrary. It results in the ratepayers paying twice for deferred accumulated depreciation and four times for the annual depreciation expense. Nor is it clear that the ratepayers who agreed to these terms understand their implications as to future rates.

For these reasons, Staff has proposed an alternative that allows the Commission to achieve the rate results without creating a precedent for accounting practices with apparently unintended consequences. To accomplish this, Staff proposes adopting its recommendations regarding rate base, operating expenses and depreciation rates and retaining the revenue requirement and revenue increase (with the three-year phase-in), the rate design and the Stay-Out provisions.

IV. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations on the disputed issues for the reasons stated above and the testimony provided.

RESPECTFULLY SUBMITTED this 2nd day of December, 2011.

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[22] It should be noted that only Bourassa and Rigsby so testified, but the remaining intervenors did not dispute their position.

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